

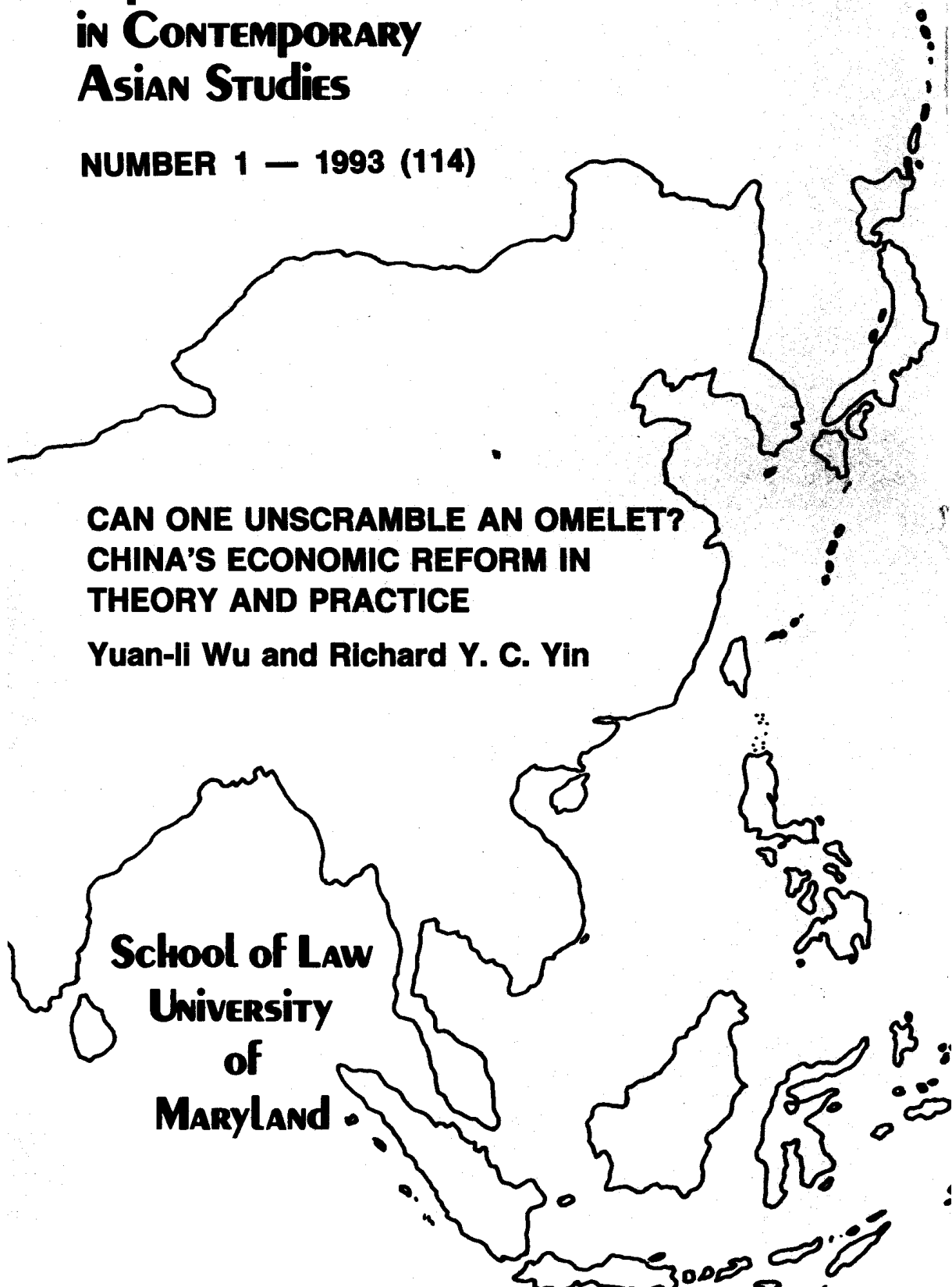
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**CAN ONE UNSCRAMBLE AN OMELET?  
CHINA'S ECONOMIC REFORM IN  
THEORY AND PRACTICE**

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*Yuan-li Wu\**  
*Richard Y. C. Yin\*\**

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# **CAN ONE UNSCRAMBLE AN OMELET? CHINA'S ECONOMIC REFORM IN THEORY AND PRACTICE**

## **I. INTRODUCTION**

Economic systems under socialist central planning in both Asia and Europe, notably the People's Republic of China and (until its officially proclaimed demise on December 8, 1991) the former Soviet Union, have all begun to undergo economic reform, or have at least proclaimed the desire for reform during the past decade. China started about a decade ago; the Soviet Union, after some hesitating steps and theoretical plans (notably the Shatalin "500-day plan") had barely begun seriously before the USSR itself was no more.

As of this writing (mid-1992), we do not yet know what to expect of Russia and other member republics of the newly-formed Commonwealth of Independent States. Eastern European countries which, scarcely three years ago, were still under the military occupation of Soviet troops as a result of World War II are at different stages of evolution in economic transformation. North Korea, Cuba and Communist Vietnam cannot as yet be properly placed in this same category of truly aspiring and committed economic reformers.

Theoretically, one could array the above countries according to some index measuring the degree of each country's movement toward a "market economy." Alternatively, they could just as well be arrayed according to the degree to which their economic reforms have encountered economic/political difficulties. The obstacles to reform can themselves be divided into different categories within which there are differences in degree and kind. Perhaps the single common denominator shared by the majority of these countries is a desire for "gradualness," for a "slow-down" of change.

The case of German reunification is a good example. In a sense, by being absorbed into the West German economy, the former German Democratic Republic (GDR) can be said to have taken the fastest route of institutional transformation; Poland may be the next in degree of radical reform. Hungary and Czechoslovakia probably also rank high in the process. The rest of the socialist countries have either hesitated or are still experimenting. The PRC has had more time in trying different specific reform measures and has made not only a few lengthy pauses, but also some very sharp about-faces. Its state sector, espe-

cially in industry, is currently mired in the aftermath of one of those violent about-faces.<sup>1</sup>

One cannot easily measure the distances that still lie ahead between a command economy, at least partially centrally planned, and a "market economy" because the necessary characteristics of the latter as a "target" are not often precisely defined at the outset by reform advocates. Economists, not to mention politicians and the general public (in both Western and hitherto Soviet-type economies) are themselves vague about these conditions — sometimes deliberately so.

Conversely, if one attempts to measure the number of obstacles overcome by specific reform efforts, one cannot readily equate these obstacles one against the other in terms of their severity and importance. The Soviet Union under Gorbachev tried to give precedence to political rather than economic reform. Mainland China under Deng Xiaoping in the decade of the eighties and his anointed successors since the summer of 1989, have to date affirmed their intention to pursue economic reform under "socialism" as they see it, while maintaining with equal vehemence their own political dictatorship. The Dengist leaders obviously either do not see any inconsistency in their position or do not have a choice simply out of a dire sense of insecurity. The former satellites and subjugated nations within the Soviet empire have in effect begun to pursue both political liberalization and economic reform almost simultaneously. The collapse of Soviet power occurred very rapidly so that demands for national liberation, political democracy and economic reform have become intertwined. There simply has not been sufficient time to sort out the extent to which these three objectives are, or are not, mutually dependent.

Given the historical events that began with the post-Mao economic reform of the 1980s and culminating with the East European and Soviet political revolutions and apparently still unfolding economic transformations, what the authors of this paper started out as a limited effort to explain the technically economic aspects of transforming a command economy now becomes a much more extensive discussion of international political economics.

On the basis of the above developments, the authors of this paper will begin by addressing, in fairly elementary economic terms, why the

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1. This paper deals principally with state enterprises. The Chinese private sector is still limited in size. Enterprises in "villages and townships" are often established by local governments as their agents, and should not be identified with private business. Geographically, enterprises in several Special Economic Zones seem to be doing well according to outside observers. But a comprehensive account of economic conditions in the 2000 plus counties of mainland China is still lacking as of 1992.

introduction of free market prices and the freeing of managers of state enterprises from detailed commands do not automatically initiate a process that leads to equilibrium in individual markets. Nor can the determination of relative prices that would bring about a more rational reallocation of resources be pursued independently of price stabilization and the necessary coordination of monetary and fiscal measures which must, however, be predicated upon new institutions and attitudes that are not yet in existence.

This relatively technical discussion found in sections I and II relates to basic economic principles used in Western countries classrooms where students whose lives have always been spent in market economies are now perplexed by the many complex conversions involved in a shift from a command to a market economy. The same discussion is also addressed to self-taught students who find that the equilibrating processes described in Western microeconomics texts and macroeconomics principles bear little practical resemblance to what their own reformers prognosticate and what they perceive as economic realities.

Having come to grips with the micro- and macro-economic details, members of our initial readership will readily see that the discussion in section II overlaps especially with that of section III. Essentially what happens is that when the production of goods in short supply does not rise as expected or when inefficient producers continue to be subsidized, individual economic decision-makers will do what they deem to their advantage, regardless of reform measures and intentions. This applies both to the public and the government and enterprise managers at various levels. Hence, what began in this paper as a technical discussion of economic principles moves imperceptibly but logically into a discussion of "political economics."<sup>2</sup> Difficulties encountered in economic reform can be of political origin, while inability to make the requisite political changes in turn leads to economic actions that have other political consequences.

Because the authors of this paper are also long-time students of contemporary China, we turn finally to an illustration of our analytical findings through factual observations, including foreign as well as Chinese comments in the by now fairly rich but still disjointed literature on the Chinese experience. The paper ends with some ideas about the future of China's economic reform which is still far from being

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2. The classical term "political economy" may actually be equally appropriate in the present context. We have, however, used the term "political economics" to stress the political aspect of individual, enterprise, and institutional behavior in the economic reform efforts of socialist administered economies in order to draw the readers' attention.

settled. It may be that a real solution can only be found if one looks beyond the narrowly economic sphere.

## II. A MICROECONOMIC ANALYSIS OF THE ENTERPRISE, THE INDUSTRY AND THE MARKET<sup>3</sup>

### *Perestroika and Potential Adjustment to Price Change by an Individual Enterprise*

The motivation of a change in economic policy away from socialist state planning initially stems from the policy maker's desire for (1) an increase in aggregate output, accompanied by (2) an increase in individual goods in short supply, (3) a cut-back in production of goods oversupplied at the prevailing prices, and (4) an increase in efficiency, including a change in production (and organizational) methods that would reduce cost, without, however, (5) a serious detrimental impact in distributive terms. From the overall economic point of view, the change in goods produced and in the allocation of resources for their production would consist of a change in the economic structure; this is structural change or transformation, *perestroika* in the narrow sense. What happens when such a policy of economic reform is earnestly pursued in a centrally administered socialist economy? (We shall disregard for the moment the distributive aspect under point 5.)

First, let us consider the case of an individual state-owned enter-

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3. Among the numerous books and articles on China's economic reform, the authors have found the following particularly useful for their purpose: Chen Yi-zi, *ZHONGGUO: SHINIEN GAIGE YU BAJIQU MINYUN* (China: A Decade of Reform and the Democratic Movement of 1989) Taipei: Lien-ching Publisher, 1990; Cheng Chu-Yuan, *BEHIND THE TIANANMEN MASSACRE: SOCIAL, POLITICAL AND ECONOMIC FERMENT IN CHINA*, Boulder: Westview Press, 1990; Liu Guoguang, *ZHONGGUO JINGJI DA BIENDONG YU MAKESI ZHUYI JINGJI LILUN DE FAZHAN* (The Great Transformation of the Chinese Economy and the Development of Marxist Economic Theory) Jiangsu Renmin Chubanshe, 1988; Jan S. Prybyla, "A Systemic Analysis of Prospects for China's Economy," in U.S. Congress, Joint Economic Committee, *CHINA'S ECONOMIC DILEMMAS IN THE 1990s: THE PROBLEMS OF REFORMS, MODERNIZATION, AND INTERDEPENDENCE*, Washington, D.C.: U.S. Government Printing Office, 1991, Vol. 1, pp. 209-225; Zhang Zuoyuan and Huang Fanzhang, *ZHONGGUO SHINIEN JINGJI GAIGE LILUN TANSUO* (Theoretical Explorations of China's Decade of Economic Reform), Beijing: Zhongguo Jihua Chubanshe, 1991; William A. Byrd, *The Market Mechanism and Economic Reform in China*, Armonk, N.Y.: M. E. Sharpe, 1991; and Jan S. Prybyla, "China: A Question of Modernization, Socialism, Culture, and Economic System," paper presented at the 33rd Annual Meeting of the American Association for Chinese Studies, University of Virginia, Charlottesville, Va., November 11, 1991.



prise producing a commodity in short supply at an officially fixed price much below what would be the market price if all the enterprises producing the same good were allowed to make what they could, compete vigorously with one another and charge whatever price they could get for their product. How this enterprise would act under economic reform when price control is removed is what the advocates of reform would like to know. Would it differ from what a firm all the time under the market economy would do?

In order to answer this question, let us review briefly what a single firm would do under perfect competition in conventional microeconomics, assuming that the firm is in operation and producing at a unit variable cost more than covered by the price, which has been set by the government.<sup>4</sup> Once the ceiling price has been lifted, this firm could respond to the prospect of greater profit (or less loss if the normal return on its fixed investment is still not fully covered) by producing more.

However, if the firm is a state enterprise operating strictly under the command of the State Plan, then both price and the quantity produced, as well as the input requirements, should be determined by the plan authorities. At the price and production target set by the authorities, if the management of this state enterprise rigorously follows these commands, the hypothetical short-run supply should be completely fixed and invariable because by assumption that would be the most efficient production arrangement chosen by the planners, which is one of maximum efficiency.

However, in the real world of the planned command economy, state enterprises are generally exhorted to do better than the plan requires, which, strictly speaking, should not be possible if the enterprises were already producing at maximum efficiency and technical input and cost standards were rigorously followed. Given the exhortation to exceed the targets of the plan, a "real world" state enterprise will strive to reach a potential "above quota" output for which the management hopes to receive a reward for itself and the workers. This can be done by persuading the authorities to set the original planned production quota and input standards below their respective maximum efficiency levels, by short-cutting some of the technical norms, by working overtime, etc. In practice, to make such an above-quota performance possible, it would be prudent, and perhaps necessary, to hold available larger than the necessary minimum amounts of parts,

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4. In basic theory, at this price, privately-owned firms would not shut down, although they may not be earning enough to stay in the industry in the long run.

materials and labor in store, which implies producing during normal times at below true optimal efficiency (with a larger than necessary inventory) and with redundant labor on hand.

Suppose as a result of economic reform, the Plan authorities wish to alleviate the shortage of this commodity and, by resorting to material incentives of the market economy which they deem permissible (such as permitting bonus payments to workers and managers), the authorities now raise the government-fixed price to a higher level. (The higher price may still be below the market equilibrium price, which we shall assume to be the case. But the authorities really have no way of knowing ahead of time where equilibrium lies.) Production can now rise, and both the scale of the firm and the size of the industry will expand. But to produce more in response to some capitalistic incentive such as a higher price and bonus payments due to larger profit, the extent to which the prospect of greater personal gain can make a difference will depend upon the quality and attitude of the management, its past experience and "ideological purity." The exact nature of the most appropriate material incentive may even be a matter of debate.<sup>5</sup> For instance, how the tax on the profit of an enterprise should be calibrated and how wage and profit rates should be determined are by no means a matter of generally accepted practice. A Party bureaucrat managing the enterprise may prefer to sit tight and wait for orders for fear of a change in official policy away from reform and of the resulting punishment he would receive. It may be hard to imagine that even the most dedicated cadre would resist material benefits wrapped up as a capitalist market incentive. However, a veteran survivor of successive Chinese purges may think twice, or even longer.

As another example, a manager may distribute cash meant to be a reward for exemplary performance as a general wage increase. At the very least, such a "market response" could be deliberately delayed by a manager until it is safe. In a country where waiting for orders has become a way of life for more than a generation, psychologically such a state of mind does not go away immediately. Hence, even the textbook's short-run supply (which permits an increase in production) may remain unchanged in spite of the rise of the price set by the state. On the other hand, if the management does respond openly to the price increase and production goes up, one might then point to the elasticity of supply exhibited by the firm as a result of the price in-

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5. The following are some typical examples of how behavior depends upon perception on the part of the person(s) who must act. The behavior may therefore be more politically than economically determined in the usual sense. But it is no less "rational" given all the circumstances.

crease. The magnitude of this price elasticity of supply could be a function of time (for example, how long it would take to feel safe for the state enterprise managers to behave in this manner), or it may depend upon the pre-reform condition of the firm, (i.e., whether spare inputs are on hand). Conceivably, the enterprise unit might not be in any condition to raise production. Time may also be necessary to "negotiate" with higher authorities for a larger supply of inputs.

The situation could be more complicated still. For instance, the state enterprise may have available more than one technical combination of inputs to produce a certain good and is told by the pre-reform Plan authorities to employ that combination which has a particular (presumably the lowest) unit variable cost. Each of the input combinations, however, may not exceed a ceiling output level set by a factor of production available only up to a fixed amount — say, some specialized machine — and increasing output beyond the ceiling would entail a change in the production method used, possibly even through leasing of extra specialized machines. The supply elasticity would depend upon both the size of the product price increase and the composition of the constraining fixed factors and their relative amounts.

Suppose these constraints are specialized machines. Whether their "mix" can be altered in the short run, or in any given length of time (a month, a quarter, etc.) depends not only upon the "short-" or "long-run" time dimension to which we are accustomed in basic economic analysis. In the context of economic reform it depends no less upon the freedom that management in the enterprise enjoys in altering technologies and the mixture of fixed assets used in production through equipment purchase, sale or lease. The "freedom to manage" is one aspect of property rights. Which of the different attributes of property rights the management of a state enterprise possesses under economic reform becomes immediately a very relevant question. Even at this early stage of our analysis, we can see how the response of an enterprise to economic reform depends not only upon (1) the level of price change (in the present case of a good in short supply, the level of price increase), but also upon (2) the management's expectation of the duration of the reform policy, (3) the experience the enterprise has had with the government and Plan authorities in terms of reward and punishment, and (4) the rights to which state-owned enterprises enjoy in using and disposing of some or all assets under its control at any time. These factors can all affect the value of the firm's elasticity of supply.

*Assumptions Underlying the Expansion in Scale of a Firm or of an Industry in the Market Economy*

In a market economy depicted in the usual microeconomics textbooks, when a firm expands in order to earn a higher profit, the implicit assumption is that its demand for labor and material inputs will be met by purchases on the market. If the market is assumed to be one of perfect competition, the additional inputs required by the expanding firm, which is, under the competition hypothesis, very small in relation to the size of the market, will be provided from a perfectly elastic supply of inputs. At an even more basic level, there is the additional theoretical assumption of "perfect knowledge" under the concept of perfect competition. This means that the expanding firm will have no problem in knowing where to turn for the inputs required from outside the firm's inventory or from its own production and in actually doing so successfully. In this connection, a small supplier in the service trade or a subsistence farm, being relatively self-sufficient, may be able to respond much more effectively to the stimulation of a price increase than larger production units in manufacturing.<sup>6</sup> Hence, what production sectors will be selected for the implementation of economic reform at the initial stage can be very important in its success or failure in expanding supply.

**A. Intra- and Inter-Firm Considerations**

In the real world of state-owned enterprises in a socialist planned economy, the preceding assumptions about information and an elastic supply of inputs are far from being automatically true. A few considerations can be listed:

(1) *Inadequate information.* A state-run undertaking set free for the first time to operate as a free enterprise may not know where to look for additional inputs if it had always turned to higher authorities for guidance up the chain of command in the planning system. The implicit assumption of the existence of established input markets (e.g. wholesale markets for materials and supplies) and sources of public information including trade associations, directories, even "yellow pages" of the telephone system may be faulty. The "usual sources" of information are often unavailable or inoperative in practice. Hence, the need exists for go-betweens in a planned system that does not oper-

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6. This explains why "side-line" nonagricultural activities initiated by farmers can grow quite rapidly. But if such small businesses expand beyond a certain scale, they will encounter the same problems of inelastic input supply and resistance from the state sector discussed below.

ate according to plan. The missing institutional links will inevitably add to costs. But instead of looking at the rise of a new profession of information dealers as an improvement upon market signals and contacts, authorities may make such dealers the target of discrimination.

(2) *Sequence of planned reform.* At a given time during reform, other enterprises supplying some of the required inputs may not have yet been included in a "phased" economic reform program if "gradualness" is the key word. If the enterprise is vertically highly integrated, some of the inputs at one stage may be procurable from an "earlier" stage. But easier access to internally supplied inputs in this case still rests on an efficient system of internal control and financing within the enterprise.

(3) *Immobility of inputs.* Inputs may not be free to move to a new employer as a result of contractual or regulatory practices. For example, workers may have to be released by their current employer before they can seek new employment, or transportation and housing at the new place of employment may be totally inadequate, thus precluding relocation. Similarly, such a "horizontal" contracting system for inputs may not yet have been put in place. Aside from economic reasons, population control in authoritarian countries usually requires certain permits for residents, and the permits are in turn the basis of ration cards and allotment quotas for goods in short supply. Increasing factor mobility threatens to loosen political control.

(4) *Financial and macro factors.* The inelastic supply of inputs may be of a financial nature. Either working capital or the financial wherewithal for long-term capital expansion may be subject to an inelastic supply, or the budget of the enterprises may be subject to administrative or even purely arbitrary allocation (i.e., subject to the personal whims of high officials). On the other hand, some state enterprises may enjoy cozier relationships with state suppliers of credit than others. This would raise problems of inequity and non-competitive markets.

(5) *Cases of joint demand and supply — transportation.* When additional inputs have to be acquired for expansion, they have to be brought to the site of production. Conversely, production increases must still be taken to market. One can conveniently think of this need for transportation and marketing service as cases of joint demand and supply of inputs and outputs, respectively. Given the socialists' ideological predilection of ignoring merchandising among "productive" economic activities, it would not be surprising to find supply inelasticity if "supply" is understood to mean actual delivery at the place of use. For different kinds of goods, speed of delivery and the distance

between the site of production and the market are determining factors. For instance, truck farming of fruit and vegetables grown immediately outside a city for its residents can be quite sensitive to price fluctuations. On the other hand, the supply of coal that must be shipped by rail over long distances may not be responsive to increasing demand if rail traffic is congested.

In short, the elasticity of supply of a commodity cannot be regarded as independent of that of its input supply. Inclusion of the means of financing and the firm's budgetary control in consideration makes the individual firm's response to price and profitability changes also dependent upon the prevailing financial regulations and, therefore, a function of monetary and budgetary policy. Economic reform in the micro sense therefore encounters the need for macro-economic reform.

#### **B. Changing the Size of an Industry.**

The traditional approach in micro-economic theory generally divides problems of adjustment into three categories: instant, short-run and long-run adjustments, as well as intra-firm and inter-firm relations as factors causing changes in the size of the industry. In a socialistic economy, the conditions of a state-owned enterprise and the size of a pre-reform industry can vary a great deal from country to country, so that factors affecting adjustments in perestroika become less distinct among these categories of classification. The following distinctions, which cut across the aforementioned Western textbook classifications, are important:

(1) In a country like the PRC, arbitrary combinations and mergers of formerly private businesses and other institutions were carried out in the mid-1950s in conjunction with their nationalization. These steps were taken in the name of efficiency through specialization and geographical relocation. This process, if carried out consistently, tends to increase the size and degree of vertical integration, with some inevitable effects on the typical enterprise. The larger the enterprises, the greater the possible degree of vertical integration, but such a reorganization does not necessarily diminish the need for the "horizontal" demand for outside purchases. Furthermore, the larger the individual enterprise, the more likely is its financing a matter of concern to the government's fiscal planners and, therefore, more susceptible to administrative interference.<sup>7</sup>

(2) In the PRC economy, a "planned sector" exists alongside an-

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7. According to former members of the PRC bureaucracy, personal directives were

other sector that is treated as "outside the plan." Rules governing new investments may differ between the two sectors, thereby leading to differential rates of change in enterprise size and rates of investment between the two sectors. Similarly, the size of an industry can be affected by different rules governing new entry into a particular sector. Presumably new entry would be less rigorously controlled, or not controlled at all, if certain enterprises or a whole industry were placed "outside the plan." Conceivably, different rules may be instituted with respect to different types of ownership — in the Chinese case, "individual proprietorships" are permitted for a limited number of industries (e.g., personal service and some consumer goods production) which are less strictly controlled than other forms of ownership, such as "collective enterprises" or "joint state-private enterprises," not to mention "state enterprises." Enterprises belonging to different categories or sectors may not enjoy equal access to the market of inputs and capital.

(3) The high degree of centralization in administrative control has always been a characteristic of excessive bureaucratization in the socialist economy that invites criticism. Consequently, over the years, decentralization of control has often been introduced as a reform measure. The Soviet Union and the PRC have both undergone such reforms in the past. Where "regional," "local," "provincial" or "zonal" (e.g., the PRC's special economic zones) authorities enjoy autonomous control over the establishment of new enterprises and/or the allocation of special inputs, their interest in defending and even expanding their own jurisdiction can lead both to a desire for establishing new firms in their own territories and also in making similar efforts by others more difficult. For instance, if textile exports appear to be a profitable source of foreign exchange, every cotton producing province in China enjoying such authority would wish to set up cotton textile manufacturing while the same authority may wish to impose export restrictions on outward cotton shipments or transshipments.

This is but another instance in trade theory of multiplying the number of territorial divisions for localized areas of trade protection and self-sufficiency. Hence, "decentralization," which seems to be such an obvious way of increasing efficiency in economic planning, can contain serious elements adding to inefficiency and confusion by multiplying centers of decision-making with possibly divergent economic or even political goals. Hence, it is not at all surprising if advocates of

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occasionally issued by top officials that bypassed the usual process in making decisions on even major investment projects.

economic reform can become proponents of recentralization of control. On the demand side, there is the possible fragmentation of the market and its potentially adverse effect on the economy of scale.

In textbook discussions, theoretically, the industry's supply in a socialist system undergoing economic reform can also be derived like that of an industry in a competitive market economy, through the summation of the supply schedules of the individual state-owned enterprises. The elasticity of the industry's supply schedule may be greater due to (a) the larger the number of individual enterprises operating as separate entities, each trying to maximize profit on its own, and (b) the more varied the technologies and, for each of them, the fixed assets or other constraints to which every enterprise is subject.

For an economy that underwent nationalization some time earlier, additional factors must be taken into account: (i) If historically there had been a merger movement which reduced the number of independent enterprises, it may have simultaneously reduced cost. This happens because of the relaxation of some fixed factor constraints and the greater degree to which available lower variable cost methods can be used. Technically speaking, this means the smoothing out of some of the kinks in the individual firms' supply schedules, thus increasing the continuity of the industry's supply curve and possibly its elasticity.

(ii) On the other hand, the national economy can be subdivided into regional markets if decentralization runs amok, thus reducing the elasticity of supply for some regions.

(iii) Finally, an industry's supply schedule can be made more elastic if domestic supply is increased through imports. Hence, the beneficial effect of imports financed by foreign aid during economic reform, and access to imports becomes a matter of vital importance to a socialist economy in transition.

### *The Case of Oversupply*

Although socialist, centrally administered economies are better known for their shortages than their overabundance, there have been cases of oversupply of some goods, a fact that is less well known. The limited increase in "transparency" in recent years regarding economic conditions in both the Soviet Union and, to a lesser extent, in the PRC has highlighted the prevalence of budget deficits due to large subsidy payments in both countries, and a part of these subsidies consists of payments to support over-supply.

The large deficits are attributed to substantial subsidies which are necessary either (1) to hold prices down, usually for the sake of equity (a distributive reason, for example, to keep the price of bread or rice



down for low-income families) or (2) to keep production steady instead of allowing it to fall in order to keep individuals currently employed in their jobs. In the first case, demand is kept high because of the subsidized low sale price, while supply is at least partially "extracted" from producers through command, preceded usually by nationalization. Voluntary supply by producers is never quite enough. Hence, shortages and long lines result, often in spite of rationing. This is the case we discussed in the beginning of the previous Section.

In case (2), goods are over-supplied at government-fixed prices, which are above the theoretical equilibrium prices, and the excess supply over demand presumably is added to inventory. This "addition to stock" or "new investment in working capital" is testimony to erroneous pricing and to resource misallocation. Institutionally, it is aggravated by the separation of production from marketing, which in turn is ideologically related to the notion that commerce does not add to value and represents exploitation by "parasitic" middlemen.

Several questions arise immediately: (1) Is the excess supply real? Or is it accompanied by a shortage?

In the first place, the excess supply may consist of goods that are substandard, or it may exist only in production statistics, but the supply never reaches the "buyer" or final consumer and may have in fact vanished long ago. For instance, fresh produce may be perishing on railroad sidings while the market place in town has high prices. Where the excess supply on the market is "fictitious," the solution is obviously not to lower price and production but to raise quality and to increase the efficiency of inputs linking production and market supply; namely, to provide information, marketing and shipping.

Second, the failure to link production and market supply is for socialist command economies a common phenomenon. To the producing state enterprises, meeting production quotas and their overfulfilment are far more important than meeting the buyers' requirements. Hence, unsold or unsaleable goods are added to inventory. Production quota overfulfilment and addition to inventory can, therefore, be associated with each other. Such a combination could well be interpreted as a sign of the plan's success because of the large or larger output, which the political propaganda machine exploits, although the large supply (or larger than "planned" supply) may actually be a result of inefficient plan performance and a waste of resources, from which the economy eventually suffers. At the same time, as we have seen earlier, keeping higher inventory than necessary may be a means of assuring quota fulfillment or over-fulfillment, thus fooling both the planners and the political decision-makers themselves.

Sometimes unfinished construction and investment projects may be cancelled half-way for lack of funds or materials — in short, they were not properly planned. The materials produced, and presumably registered in output statistics, then end up as junk.

(2) What if the excess supply is genuine? Next consider two cases of genuine excess supply, i.e., at the given price level, supply exceeds demand. First, there is the case, “keep the worthy cadres employed.” If the price is lowered, economics textbooks would point to a fall of supply leading to the use of fewer inputs and, in the longer run, a smaller plant and a shift of fixed assets and investments out of the industry. Making the individual enterprise responsible for its own financial performance would automatically lead to its contraction; competition among the supplier(s) would further lower the product price and cause a shrinkage of the industry. If this process continues, the inefficient enterprises would become insolvent and go out of business. This process of contraction is a necessary part of structural change (*perestroika*) in the narrow sense and does take place in the market economy where even very large private firms go bankrupt when excessively high losses are incurred for too long. This has happened during 1991-1992 in the United States.

However, specialized inputs may not be transferable, and one such redundant input in the PRC, as in other reforming socialist economies, consists of labor in the form of the many Communist Party cadres in managerial and supervisory positions (including functionaries in Party cells).<sup>8</sup> If economic reform takes place after a period during which the managerial personnel has been selected on the basis of Party loyalty, ideological purity, and/or excellence in Party infighting or out of other factional (or family) considerations, or as compensation for wrongs suffered in previous political struggles (e.g., the rehabilitation after 1976 of cadres ousted during the Cultural Revolution in China), such “specialized workers” might not be employable anywhere else. They would therefore be advocates against contracting the enterprises and industries in which they are employed (but may not really work) and against the adoption of any bankruptcy law if none previously existed. This may be regarded as *generalized political nepotism*.

In a second case of excess supply in which producers do not have

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8. The problem is aggravated by the large expansion of CCP organs and personnel controlling the economy and government. See Hu Chi, “Dalu de jigou pengzhang he jigou gaige,” (The Multiplication of Administrative Agencies and Administrative Reform in Mainland China), in *TAN SO* (Quest), Brooklyn, N.Y., No. 107, November 1992, pp. 20-23.

to take demand as given, the management may actually try to promote demand, through export if not in the domestic market. One could include the PRC's exportation of the products of its arms industry in this category.<sup>9</sup> Expansion of this industry sustained by government demand has apparently helped sustain an over-blown arms sector and its "military-industrial complex" in both the Soviet Union and the PRC. Budgetary retrenchment and the consequent lagging domestic demand in the absence of large-scale fighting have naturally encouraged the industry's managers to explore export markets. Should these exports prove highly profitable and expandable, what might otherwise be a contracting industry could turn around and thrive. This could become a case of exporting potential domestic social and political discontent to foreign trouble spots, destabilizing areas of political conflict abroad in order to save one's own protected groups.

### III. MACROECONOMIC ISSUES: MONEY, BUDGET DEFICIT AND RELATED MATTERS

We began this paper by pointing to a dual problem confronting the task of *perestroika*: excessive actual "effective demand" relative to aggregate supply and the production of a wrong "mix" of goods and services. So far we have focussed on the factors that delay and lower the responsiveness of producers to relative price changes. We turn now to an analysis of some basic macro-economic issues, beginning with the difficulty of balancing the budget and coordinating fiscal and monetary policies.

#### *Budget Deficits and the Money Supply*

In the section on "the Case of Over-supply," we have pointed to the potential economic consequence of unemployment if goods nobody wants or cannot be sold at free market prices cease to be produced. These goods may be substandard or the cost would be too high in relation to sales price if both were market-determined. On the other hand, in the absence of corrective measures (i.e., acceptable bankruptcy proceedings to eliminate redundant production facilities, re-training for management and workers, and arrangements to effect ownership transfer) continued production would waste resources and create budget deficits through excessive subsidies. In the special case where the goods in question happen to be arms or drugs which the authorities do not wish to sell on the open market, redundant supply

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9. Or of other goods the import of which is illegal in the other country (arms smuggling; narcotics export).

will increase the pressure for export sales — although domestic discontent can be thus exported for a while. Export drives of other goods will probably stimulate protectionist demands in other countries. This has been one source of U.S.-Chinese trade disputes in the 1980s.

If the above situation has lasted for a long period of time, the monetary phenomenon corresponding to the excessive inventory of both arms and non-arms is generally known as the “monetary overhang,” a lot of money is held in savings accounts and “under mattresses,” with nowhere else to go. But its very existence has certain consequences:

(1) While it enables buyers to rush to purchase scarce goods in demand that make their appearance in state stores from time to time, it also makes possible runs on goods when actual or rumored shortages occur.

(2) Excessive liquidity enables producers of goods to raise prices and practice price discrimination in segmented markets instead of increasing market deliveries as a response to the freeing of prices.

(3) In the worst scenario described in the last section, where prices are freed, scarce goods will not increase in supply very quickly but their prices will rise. At the same time, goods already over-supplied will not decrease quantitatively and the expanding inventory will accompany an increasing monetary overhang.

(4) Price increases and worsening shortages will further raise costs and “cost-push” price increases will pile on “demand-pull” increases. Together they can exert political pressure on the authorities to increase the supply of money (mostly by printing more money). These are the ingredients of hyperinflation. These tendencies can be further aggravated by the authorities’ belief, at least at one time under Zhao Ziyang in the mid-1980s, that an inflationary policy can stimulate development.

### *Demonetization and Return to Administrative Controls*

If shortages persist while the money overhang continues to expand, and if repressive controls of the buying public are reduced, price increases are bound to accelerate. We can then anticipate a variety of counter-measures designed to safeguard the government’s command over resources and to cut back the existing money supply.<sup>10</sup> These

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10. For a discussion in English on money and its role in the PRC, see Gavin Peebles, *Money in the People’s Republic of China: A Comparative Perspective*, Sydney, London and Boston: Allen & Unwin, 1991.

measures which the authorities are likely to consider might well include:

- (1) reinvocation of direct administrative controls in allocating resources, i.e., a step back in economic reform (reducing the elasticity of supply of inputs to industries and firms freed from micro-controls);
- (2) as a minimum, retention of rationing and price controls for essential consumer goods, possibly delaying the popular expectation of expanding personal consumption as soon as an economic reform program is initiated or following the acceleration of such a program;
- (3) cutting down the stock of money held by the public and reduction of the flow of money reaching the public.

Since credit policy as a means of regulating demand through business and personal spending in a market economy is yet to be instituted as an integral part of economic reform, there are not many options involving monetary control to curb price inflation in a centrally administered economy. Decreeing that bank notes of certain large denominations are no longer legal tender was apparently attempted in the Soviet Union not too long ago, although the net effect would seem to be more in line with the demonetization of the currency as a whole than the contrary.

In all historical experiences of European and Asian (post World War II Chinese) hyperinflation, the persistent and accelerating increase in prices is a sure way of driving people to forsake the currency for goods and other items perceived to possess greater stability in value. Long before the post-1985 Gorbachev era, the ruble had become progressively less acceptable as a "store of value." Since the introduction of "glasnost," lack of complete "internal convertibility" of the ruble has been openly discussed. If a country's official currency were totally inconvertible into goods, it would be demonetized. The authorities empowered to issue it would then be without means to acquire goods and services except by command or through direct ownership. Nor can the government force the population to use and, therefore, accept a rapidly depreciating currency unless it is able to sell goods in demand itself and accept the currency in exchange. These conditions imply that in order to bolster the acceptability and stability of the currency, retention of a rationing system of essential goods at relatively stable prices is, in effect, a last-ditch defense against total demonetization of the national currency. At a time when prices rise rapidly as money is spent to disperse a massive "overhang," even those persons in the government advocating economic reform and marketization in the long run may hesitate to reduce the government's even-

tual direct command over tangible goods through privatization, in spite of the revenue that the sale of state assets may produce.

*Monetary Policy and the Need for a New Financial System*

The preceding section points to macro-economic consequences of persistent shortfalls of supply in relation to the demand for specific commodities and the failure to correct over-supply and to effect a reallocation of real resources. We turn below again to the mechanism of resource allocation and of increasing over time the aggregate supply of goods at, hopefully, prices at which they will be taken off the market while yielding returns to their producers who will be satisfied in the long run.

Before the initiation of economic reform, the state planning authorities dictated both the macro (i.e., aggregate) levels of demand and supply and the sectoral and inter-enterprise allocation of resource use via the annual and long-term state plans that incorporate the material balances. The fact that a great deal of "money overhang" ("hoarding" in traditional monetary parlance) has come into being and that some goods and services are woefully short while others are either wasted or produced without anyone wishing to use them testifies to an obvious truth, that the plans have gone awry. So, if the planning or command system is to be scrapped in favor of individual businesses and persons raising their own funds, apart from the latter's wage and profit from personal income, how can this be accomplished? If state enterprises are progressively privatized and if taxes must replace profit remitted by the enterprises to the state treasury, how can revenue short-falls be covered? Where can the central and lower-level governments borrow or otherwise raise money? Where do the "loanable funds" come from?

This series of questions which macro-economics texts deal with suggest that socialist economic systems undergoing "marketization" must either establish or re-establish *institutions* and *practices* that can perform the dual tasks of (a) efficiently allocating funds through loans or equity purchases to users of capital for varying lengths of time and (b) influencing the demand for and supply of funds from both public and private sectors. Fulfillment of these tasks can run into problems, a few of which will be enumerated here:

(1) The Public Sector's Demand for Funds May Be Insatiable.

The unbalanced budget can be a result of continuing subsidies to the goods-producing sector as the above discussion has shown. The original centralized, authoritarian system has an overburden of administrative, Party and military personnel (including police), the reduc-

tion of which will encounter strenuous political resistance and likely sabotage, if not open rebellion. Among the disadvantages of decentralization accompanying economic reform, regional and local levels of political authority may exert undue influence on the lending institutions, thus making control over the aggregate level of credit impossible. If foreign banks have entered the country, their legitimate business operations might further complicate the control of money supply.

(2) Evaluation of Profitability and Credit Worthiness May Be Impossible.

Efficiency in allocating funds requires that borrowers can evaluate the potential profitability of projects for which funds are sought and that lenders can evaluate the risks the provider of funds must bear. It is hard to imagine how both sets of calculations can be made if the very basis of price-setting (including taxes at all levels) and of property rights (including mortgages and collaterals) are not sufficiently established. Needless to say, tax codes, fiduciary obligations and commercial and economic laws in general must be developed. If financial intermediaries other than banks are to be developed and their network is to cover a large terrain, one can well imagine the scale of this daunting undertaking.

(3) Can Indebtedness Run Amok?

At this point, one might speculate on one possible consequence of the inability to evaluate risk. Suppose a business borrower of funds from a bank or a buyer of supplies from another enterprise is unable to meet the terms of a loan or purchase contract. Is the delinquent party to be cut off from future funds or supplies? Can recognition of bad debts be postponed — a practice not unknown to some Western banks in recent years imprudent enough to have made bad domestic as well as foreign loans? If the bank lender or business supplier has had to borrow as a result, what will happen to the pyramiding effect of debt due ultimately to the incompleteness of the perestroika process in place?<sup>11</sup> Will the government be forced to come to the rescue? Will such a bail-out add to the prospect of hyperinflation?

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11. This is the "triangular debt" problem that faces China in the early 1990s.

#### IV. CHAINS OF ANTI-REFORM EVENTS (REFORM AS AN INTER-ACTIVE AND "AUTO-REACTIVE" PROCESS)

Once the fixed price system is breached through the initiation of price variation in economic reform, the adjustment of one enterprise, or its failure to make the necessary adjustment either for reasons of its own or because of the failure of others (e.g., inelastic input supply), is likely to be followed by further consequences. However, the chain of events may turn out to be quite different from what advocates of reform originally expected. The logic of the successive developments is also subject to diverse interpretations depending upon the timing of the observation and the causal factors the observer assumes to be relevant. At this point, the issue of gaps between perception and reality arises. The following are some special cases:

(1) Some enterprises producing goods in short supply can now raise their product price, but supply is inelastic because the decision-makers in the enterprise are psychologically not ready to make the correct response and/or because input supply cannot rise quickly enough for a variety of reasons (See Section I). After some time, both the product enterprises and the input supplying enterprises may discover that they can do better for themselves by not trying to increase supply but by merely acting in unison, with other producers, if necessary, and simply charge higher prices.<sup>12</sup> This monopolist's approach is more probable if supply is provided by one or a small coterie of state enterprises run by interlocking family members. (There may not be other large enterprises in the relevant market to worry about if previous mergers have eliminated them.) In the extreme case, a single monopolist state enterprise may have cornered the local market; it can practice price discrimination and charge what it can in even more highly segmented markets. This condition can continue as long as new investment by a reformist government, or through the entry of new competing enterprises, does not appear on the horizon. If the usual balance of payments barrier is offset by foreign aid, imports can also fill the gap, at least temporarily. In order to forestall the above development, a restrictive monetary policy advocated by reformers out of concern about any existing monetary overhang would be helpful.

(2) However, some firms may actually expand supply in response to a price increase, and thus inputs are drawn to them and eventually away from other non-expanding enterprises. (The existence of different categories of enterprises in the eyes of the government may contribute

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12. "Conspiring" to restrain trade under Western anti-trust law.



to this development because it may wish to encourage selected categories.) At the same time, the enterprises that should contract may refuse to do so for reasons given in the last section (e.g., fear of the unemployment of cadres). They instead will appeal to the state or Party authority and invoke the argument that supplies essential to key sectors of economic or national interests (e.g. defense) must be protected. The administrative allocation of resources (e.g., construction materials, special steels, fuel, etc.) can be invoked or reinvoked, and the initially expanding sector is stopped in its tracks. This would be consistent with the usual practice of the command system, if that is what the decision-makers understand and can rely upon.

(3) Consistent with the preceding thought, rising prices are not regarded as one step in the adjustment process, but as speculative excesses and antisocial behavior. Such a populist perception that the Party in power has nurtured for years is readily accepted by the population, especially if price increases described under (2) above are known to a broad section of the population. In the worst case, political sanctions are imposed. As a minimum, price controls can be reintroduced in a dual pricing system, and/or income transfers can be instituted in favor of one segment of the market (e.g., the urban fixed income group) to mollify that group's discontent. As a matter of fact, political controls that can frustrate price liberalization may be introduced by the same political group that holds an anti-reform stance and tries to hang on to power.

Where individual proprietorships have at one time been abolished, such as in rural industries in Chinese communes, or where personal service enterprises have not been allowed in cities, the start of such businesses, requiring little outside supplies and capital, can be quite fast. This fast, early growth, however, can be quickly stopped through both administrative control (e.g., licensing regulations) and deflation. This is a potential risk facing the expanding subsector of "village and township" enterprises in China in the late 1980s and early 1990s.

## V. THE HISTORICAL BURDEN

The first sections of this paper have shown how and why existing state enterprises under a socialist, centrally administered economy may not behave in the manner the equilibrating process postulates for a market economy in economics textbooks. Because certain entrepreneurial behavior and market institutions that transmit information and facilitate adjustments have been proscribed too long under the threat of severe punishment for social misconduct, the "market

mechanism" often fails to function automatically. On the other hand, now that institutions and behavioral patterns have grown under the centrally administered, socialist systems, they too cannot and will not be discarded immediately even if the punitive rules are no longer enforced.

Sections I-III of this paper contain the analysis of enterprise adjustments to reform and extend the discussion to interactions between different actors in the market and between microeconomic behavior and macroeconomic policy. A review of these sections suffices to show that we are dealing with problems involving two sets of behavior and institutions.

One set was removed at great pain and sacrifice during the time of compulsory socialization more than four decades ago in China, but is now to be reintroduced to a degree, except that the degree has not yet been determined. The other set was implanted then but has evolved into a disaster, and the present-day reformers now have great difficulty in removing it. It is now time to examine some of the principal constituent factors in the two separate sets of parameters. For the convenience of analysis of both the Chinese and other cases, we shall point out both (a) factors that are universally applicable to all formerly socialist economies now undergoing "marketization" and (b) factors that are "country specific" due to the historical experiences of an individual country, the PRC.

(1) Separation of production from distribution. The socialist, centrally administered system focuses on production and the quantitative dimension, paying little or no attention to distribution, marketing, demand or quality. The middleman who links the producer to the consumer is regarded ideologically as redundant and morally as parasitic while the equilibrating process of "buying low" and "selling high" is regarded as "speculative" and antisocial. Hence, relative price changes are not regarded as necessary market signals: (i) Price increases are abhorred and attention is not focussed on whether the anticipated effect on production is realized and, if not realized, then why. (ii) Decreases in production are always deplored without inquiring whether such a change might be a part of the structural adjustment required and might result in greater efficiency for the society. Policy makers therefore pay attention only to reducing the social pain of adjustment and the personal pain they might suffer; little attention is, however, paid to how corrective adjustments might be made under the system they have introduced and must administer.

In the Chinese case, given the several policy reversals in the last decade and the practice of uninterrupted massive political campaigns

and drives since 1949, the public finds it hard to believe in any government promise of relaxation of control. The credibility of the government is at a historical low. As long as the present Communist government does not admit its own doctrinal error, every relaxation of economic control is more likely to lead to efforts to exploit the lack of rigorous regimentation than to follow through its relaxation and establish the rule of law in the economic sphere as an integral part of China's political reform.

(2) Neglect of domestic private consumption in the centrally administered system has been the general case in all socialist economies. Emphasis in resource allocation under socialist planning has favored capital goods and producer goods for the domestic public sector, *including* the arms industry in many cases (especially the Soviet Union and the PRC) or for goods destined for the export market to pay for planned imports. Hence, the reallocation of resources required under present-day economic reform will necessarily require a downward adjustment of many previously favored industries, necessitating potentially painful adjustments on the part of their employees and management, as well as related product users and input suppliers. In this context, the political and Party bosses of the "military-industrial complex" will, therefore, most likely be against economic reform in order to defend their vested interests.

In both the Soviet Union and the PRC, emphasis on arms production and on heavy industry supporting it in order to strengthen defense has become for a long time a historical task, the validity of which is almost never questioned and examined. For some of the East European countries, the emphasis on defense and non-consumer goods may not have the same degree of "historical necessity" once the Soviet military overlord has been removed, which was what made economic reform possible in the first place.

(3) Three "country-specific" conditions have affected the PRC especially. (a) While Chinese intellectuals have frequently lamented the poverty of pre-communist China as the source of its economic woes, some have rated inequality as an even more serious problem than poverty. This proposition has made it possible for some Maoists to make being equally poor as everyone else almost a virtue. (b) The Party elders in China who still hold the reins of power at the time of this writing (notably Chen Yun and his followers) are keenly aware of the role hyperinflation played in 1947-49 in bringing about the unexpectedly rapid rise to power of the Chinese Communist Party (CCP) in post-World War II China. (c) The CCP is also aware of the historical source of peasant support in the 1920s and 1930s and Mao's error

in over-hasty collectivization and abolition of private farms in the 1950s.

When these three factors are brought together, one can readily understand why fixed, low prices for certain consumer staples are desired even at the cost of large government deficits and subsidies. Similarly, one can understand why partial privatization and decommunization in agriculture have been adopted, although the CCP had earned its popular standing before and during World War II, especially in Western circles, as "agrarian reformers," while the privatization of urban state industry has not been pursued. The Polish experience of Solidarity in undermining the power of the Communist Party has been another contributing factor to the fears of Chinese Party elders, so that they favor low consumer prices and abhor any effort to organize urban workers in the interest of reform.

(4) Because of the general lack of consumer goods, access to goods (and services) became the key to personal economic well-being and political power and stature in the pre-reform centrally administered socialist economies. Such access is in turn determined by power and position both of which come from one's role in the party, the military or the police, as well as the management of enterprises in favored economic sectors. As the economy undergoes structural changes, these same holders of power and position would oppose change unless their vested interests can survive the change. With "openness" to the outside world, access to the export market and to opportunities of forming joint ventures with foreign investors became a key to this aspect of structural change. In the case of the PRC, arms production for export through government arsenals reorganized as corporations under favored Party, People's Liberation Army (PLA, including all armed forces) and state enterprise management elites and their families, therefore, is and has become an actual outcome.

(5) Marketization does not offer guidance to the question of who should be the new private property owners. When the economy was nationalized, the property of the then private owners was expropriated, subject to modifications out of expediency. The current partial "privatization" of an arms export industry for the benefit of the military elite, though probably never viewed in this light (in order to uphold the regime of its present power holders), is one such expediency in the reverse process. But this is only a small part of a larger problem about how to devise new solutions to two kinds of issues that the market economy does not automatically provide or address.

First, one source of failure of the market arises out of the inability of measuring benefits and costs quantitatively. This occurs sometimes

from the physical infeasibility of isolating the result of actions and assigning it to specific recipients of benefit or to instigators of cost, and therefore policy makers and reformers cannot evaluate net outcomes. Sometimes uncertainties and time lags are responsible for market failures. For example, fluctuations of farm crops and the aggregate cyclical effect on supply and demand when individuals make decisions without perfect information are the causes of economic fluctuations from which the market economy has not been able to free itself. Nor can one quite distinguish a price increase due to a "cost-push" — deliberate or not — from a price increase attributable to increasing demand and money supply.

Secondly, as mentioned above, "marketization of the economy" does not tell us to whom state property should be privatized. This is a major political as well as an economic issue. If production efficiency and long-term distributive justice (including perhaps even the treatment of expropriated former owners and their heirs — perhaps even restitution in their favor) are to be seriously taken into account, there is no obvious answer that is purely economic. Some might say the issue does not matter. But it does not matter only as long as it is not an immediate political concern. However, it can easily become one and could do so in connection with the institution of an anti-trust policy to maintain competition in economic reform.

Similarly, how to allocate tasks and tax revenues between the central and lower-level governments within the public sector of a reforming socialist economy (or between splintering parts of a former united nation-state) and how to allocate total resources between the private and public sectors of that economy, including the often excessive cost of the military, are all issues requiring political solutions not unlike the problem of reducing the size of overblown state enterprises. An important universal issue is the political and administrative problem of finding replacements for the many tasks performed by enterprises usually undertaken by public, voluntary and social organizations in the market system. Such political solutions cannot be found peaceably until a generally acceptable political and legal framework is established that will enable the market economy to function expeditiously within a scope in which it could work at its best. Political and economic decision-makers in a centrally directed system are too accustomed to issuing commands as a means of dictating solutions in the same way as they would reallocate scarce materials.

It appears that few of the reforming centrally administered socialist economies have fully thought through this last issue. This is not surprising. For the end result of successful economic reform is not as

simple — if “simple” is the right word — as the creation of a market economy in the image of an existing model. For the ideal model does not yet quite exist in reality in its full glory. There are only approximations. Hence, while the obstacles of economic reform are immense, so are the opportunities and the promise. Unfortunately, too often the distributive aspect (whether it is of revenue, assets, power or access to any of the foregoing areas) tends to arouse emotions at the cost of reason, partly because costs and pains must also be distributed. That is at the heart of the problem. The separatist issues in Eastern Europe and the Soviet Union are examples of a distributive impasse essentially similar to the central-local government disputes that are progressively and more noisily articulated in China.

## VI. THE REFORM IN PRACTICE: CASES AND PROBLEMS

This section will begin with a quick recapitulation of the process of the PRC's economic reform discussed in this paper, followed by an ad hoc illustration of some of the problems encountered in the process based on the Chinese experience. The economic system that had existed before the institution of the current reform policy was an overly centralized system that relied mainly on administrative means in economic management to the exclusion of the market mechanism. In the eyes of some Chinese economists, it was a far more centralized, autarkic, and egalitarian system than those economies that adopted the traditional model of centralized planning, such as the Soviet Union and the Eastern European countries. Although it may be regarded as having served some useful purpose during the beginning years (the 1950s) by concentrating resources for the industrial construction centered on heavy industry, its shortcomings had in time become more and more glaring. The economy that emerged from the decade of turmoil of the cultural revolution in China found itself to be lagging far behind some of the newly industrializing countries in Asia, not to mention the more advanced industrialized countries in the world. This, perhaps more than anything else, led to a growing awareness among the Chinese leaders that the existing system must be reformed before modernization can be realized.<sup>13</sup>

### *Stages of Reform*

The economic reform that began at the Third Plenum of the 11th Central Committee of the Communist Party of China convened in De-

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13. See Liu, *supra* note 3, pp.135-136; also see Chen, *supra* note 3, pp.1-2.

ember 1978 may be divided into three stages: The first mainly focused on the countryside where the production responsibility system based on the household unit was instituted to replace the practice of collective labor, collective management, and centralized distribution under the commune system, which was first introduced in 1958, but subsequently modified in the early and mid-60s. At the same time the purchase prices of some agricultural and sideline products were raised, diversified production and rural markets were promoted and production incentives for the farmers encouraged. In the cities, the reform mainly concerned the expansion of the autonomy of the enterprises and a number of preliminary and experimental reforms had been carried out in respect to profit sharing between the enterprises and the state. Local governments were also given greater autonomy over their revenues and expenditures.

The second stage began with the adoption of the resolution on economic reform at the Third Plenum of the 12th Central Committee in October, 1984 when the focus of reform shifted to the cities. A series of reforms and new experiments have now been carried out to promote the expansion of enterprise autonomy, the experimentation of various contractual and lease arrangements in enterprise management, the development of "horizontal" connections, the establishment and development of various kinds of markets, the strengthening and improvement of macro economic management and the application of economic and legal, as distinct from ad hoc administrative, means in regulating the economy.

The 13th Party Congress, held in October, 1987, further stipulated the need for reform of the political system. The reform underwent a period of retrenchment in the latter part of 1988. The Tiananmen Square massacre of June, 1989 with the wholesale replacement of liberal elements in the party leadership marked the end of the second stage and the beginning of a new one. Beginning in the spring of 1992, Deng Xiaoping has tried to rekindle the reform program, and the economy now finds itself at a crossroads.

### *Problems Encountered in the Reform*

1. *Redundant construction and production* is a result of the expansion of fiscal autonomy enjoyed by local authorities. This sometimes leads local authorities to set up their own small factories employing backward processes or outmoded equipment to produce goods of inferior quality. These factories cut or suspend the supply of locally produced raw materials traditionally supplied to the established industrial centers elsewhere. The large, old and technically

more advanced factories elsewhere were in turn compelled to operate under capacity due to a shortage of raw materials. For example, numerous wineries and breweries came to be run by governments at and above the county level. Their number increased eight fold, from 1,496 in 1979 to 12,000 in 1980. Similar increases occurred in government-run knitwear, cotton goods, cigarettes, soap, household appliances, silk fabrics, plastics, leather, furs, canned milk products, printing and other industries. To critics in China, this has aggravated the "imbalance" of the national economy, reduced economic efficiency and the state revenues and is, therefore, unfavorable to the process of readjustment, a policy adopted in 1979 designed to remedy the "imbalances" of the national economy.<sup>14</sup> (See Section II, A(3) and B(3).)

2. *Existence of geographical barriers and regional blockades* had been characteristic of the existing system, with its emphasis on vertical leadership and channels of command even before the reform. Some cities in Sichuan, for example, refused to allow Shanghai and Tianjin firms to hold trade fairs of light industrial goods under their jurisdiction. Also in certain parts of Sichuan, even such producers as the Sichuan Walking Tractor Plant were prevented from marketing its products.<sup>15</sup> The new system of dividing revenues and expenditures between the central and local governments, as introduced by the reform, has produced similar results. Local governments, encouraged to increase revenues, reduce expenditures and develop production and other undertakings, are prone to take protective measures to impose blockades and restrict competition.<sup>16</sup> (See Section II, A (4).)

3. *Difficulties of large- and medium-sized enterprises.* While there have been improvements in the autonomy of the small state enterprises and their invigoration through contractual and lease arrangements, the same cannot be said of the large and medium-sized enterprises. Benefits from the series of governmental measures to expand enterprise autonomy have not been fully realized in the businesses. Powers that have devolved to them have often been seized by administrative departments at various levels, or by "administrative corporations" formed by reorganized governmental organs, thus resulting in bureaucratic sluggishness and loss of the capacity to compete. Excessive tax burdens for large- and medium-sized enterprises, inadequate profit sharing, plus all kinds of assessments and charges critically limited the amount of funds left for enterprise reform or ex-

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14. Liu Guoguang and Wang Ruisun, *ZHONGGUO DE JINGJI TIZHI GAIGE* (The Economic Restructuring of China), Beijing: Renmin Chubanshe, 1982, pp.54-55.

15. Ibid., p.16.

16. Ibid., pp.55-56.



pansion. In the relationship between the state and the enterprises in respect to income distribution, no uniform administration developed. In matters of income tax and tax adjustments, profit sharing and profit contracts, the mechanism usually takes the form of negotiation on an individual basis, and the tendency is to penalize the best and the most efficient, a phenomenon sometimes referred to as "the whip falls on the fastest cattle."<sup>17</sup> The measures for invigorating the micro-economy often emphasize the granting of power to the neglect of exerting pressure on the enterprises. Weak financial constraints over the budgets of the enterprises led to the phenomenon that enterprises are responsible only for their profit but not for their losses. Many enterprises failed to exercise self control after they have gained power through profit retention, and they often proceed to dispense excessive wage and bonus increases, thus aggravating an already inflated aggregate demand. In addition, the serious distortion of the price structure, the underdeveloped market system, the existence of regional and departmental demarcations and barriers, the infancy of the capital and labor markets all constitute obstacles to the movement of productive factors and to the full play of competitive forces. Under these circumstances, it is difficult to establish an effective economic mechanism for resource allocation.

4. *Overstock* is a long standing problem. In Xue Muqiao's report at the Party School in July of 1979, reference was made to the increase in inventory of rolled steel during 1978-79.<sup>18</sup> The year-end inventory in 1977 was 12.6 million metric tons (MMT), higher than normal level and the 1978 plan called for a reduction of 1.5 MMT. The result was however an increase of 2.9 MMT to 15.5 MMT by the end of 1978 while China was importing more than 8 MMT from abroad. Why did China import steel while shipping her own steel products into warehouses? A main reason was that the variety and specification of the produced rolled steel did not meet the demand.

Steel was not an isolated case. Xue also reported that in 1979 the inventory of machinery and electric products has reached 50 billion yuan, "a shocking waste." The problem of overstock has apparently persisted in the 1980s. A Chinese economist in 1985 referred to a "vicious circle" caused by the rigidity of cumulative chains of controls and the people's psychological tendency of scrambling for commodities brought under controls regardless of whether they were in urgent

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17. Liu, *supra* note 3, p.141.

18. Xue Muqiao, *DANGQIAN WOGUO JINGJI ROGAN WENTI* (Some Current Problems of the Chinese Economy), Beijing: Renmin Chubanshe, 1980, p.37.

need or whether they were of the needed variety and specification.<sup>19</sup> (See the case of oversupply in Section II.)

5. *Problems of shortages and overcapacity.* The proliferation of local, small industries that results from reform as mentioned above has heightened the competition for raw materials, fuel and transportation facilities. It has also aggravated their shortages. Overexpansion relative to the given market also results in under-utilization of existing and/or newly created capacities.

A recent issue of the *Economic Daily* of Beijing reported on the difficulties that some state enterprises have encountered. The textiles industry, with 40 million spindles, could utilize only 75% of its capacity because of limited raw material supply. The color television set industry, with its 167 production lines and a capacity of producing 20 million sets, has a utilization rate of less than 50% because of limited market demand. Two thousand four hundred auto factories and assembling plants include some with an annual capacity of several hundred or even less than 100 units, whereas to enjoy economies of scale one needs a production of 300,000 units.<sup>20</sup>

6. *Overinvestment*, a persistent and intractable phenomenon, is another contributing factor to the shortage of raw materials, fuel and the like. It might be recalled that the reform policy was initiated amidst the process of "readjustment" which was designed, among other things, to restrain investment. Because of overinvestment, demand for fuel and materials exceeded available supply to such a degree that shortages seriously affected the normal operation of many enterprises and construction projects. Under a practice known as the "three-eight system" in steel allocation, only 80% of allocation quota could be ordered, of which only 80 % would be delivered, of which again only 80% would be products of the requested specification.<sup>21</sup> Many enterprises had to close down three or four days a week for lack of fuel or materials.<sup>22</sup>

7. *Excessive Aggregate Demand.* In the macroeconomic sphere,

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19. Yang Qixian, "On the Reform of Economic Structure," in *DANGQIAN ZHONGGUO JINGJI WENTI TANSUO* (Explorations of Current Economic Problems of China), edited by the Teaching and Research Section of Marxism-Leninism of the Army School at Shihjiazhuang, Shihjiazhuang: The Political Academy of the PLA of China, 1985, pp. 59-60.

20. A news item in *JINGJI RIBAO* (Economic Daily), Beijing, as quoted in Central Daily News, International Edition, Taipei, Sept., 24, 1991, p.4.

21. Xue, *supra* note 3, p. 40. For an explanation of the so-called "Three-eight system," see Sun Shangqing and Chen Sheng-chang, *ZHONGGUO DE CHANYE JIEGOU* (China's Industrial Structure), Beijing: Renmin Chubanshe, 1982, p.26.

22. *Ibid.*, p.29.

Chinese planners have been confronted with the problem of excessive aggregate demand since the early 1970s. The situation was not basically changed by the policy of economic reform. If anything, the reform may have unleashed forces that augmented both investment and consumption demand. Throughout the 1980s, the problem was repeatedly highlighted in the annual communique of the State Statistical Bureau. Available data shows that the rate of demand in excess of supply jumped from 4.57% in 1983 to 16.56% in 1984 and then tapered off somewhat in the three succeeding years between 11.25% to 13.6% before it rose again to 16.2% in 1988.<sup>23</sup> China's continued increase in aggregate demand in recent years was caused by an increase in both investment and consumption demand. According to Wu Jinglian, an economist of the Research Center for Economic and Technological Development under the State Council, although the national income in 1987 increased by 82.1% over 1981, the total volume of fixed asset investment in all economic sectors increased by 278%, the loan balance of circulating funds in industry and commerce increased by 159%, and the institutional purchasing power increased by 170%. In the meantime, the per capita consumption level of both urban and rural residents increased from 249 yuan in 1981 to 506 yuan in 1987, an increase of 103% (presumably in current prices) while labor productivity during the same period rose only 50.1%.<sup>24</sup> (See the discussion of monetary policy in Section III.)

8. *Budget deficits and subsidies.* Available statistics indicate that the government's budget has been in the red since 1979. The deficit ranged from 4.1 billion yuan in 1985 to 34.6 billion yuan in 1988. Expressed as a percentage of the GNP, the deficits ranged between 1.5% to 2.5% in recent years. Of the budget expenditures, the item that has grown most swiftly is subsidies, which rose from 9.3% in 1978 to 23.7% in 1988. Of these, food subsidies for production as well as consumption led the way at first, but since 1985 subsidies for state enterprises experiencing losses have also climbed, and by 1978, subsidies for the latter stood at 13.9% as compared with those for food at 9.9%.<sup>25</sup> Another significant change relevant to our discussion has been the declining share of central government revenue in GNP (34% in 1978;

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23. Li Ping, "China's Inflation: Its Causes and Plans for Control," in *BEIJING REVIEW*, Vol. 33, No. 8, February 19-25, 1990, p. 28.

24. *Ibid.*

25. *CHINA: MACROECONOMIC STABILITY AND INDUSTRIAL GROWTH UNDER DECENTRALIZED SOCIALISM*, Washington, D.C.: The World Bank, 1990, pp. 67-68.

20.7% in 1988).<sup>26</sup> At the same time, extra-budgetary revenues have expanded very rapidly and have in effect assumed almost parity in importance with budgetary revenues. The ratio of ex-budgetary/budgetary revenues was 31% in 1978 and 94.8% in 1988.)<sup>27</sup>

9. In *macroeconomic management*, indirect economic means have yet to be effectively utilized to replace direct administrative means. A certain vacuum in macroeconomic management appeared, for instance, during 1984-85, and again in 1988, when investment, consumption, credit and foreign exchange went out of control. These factors resulted in overheating and excessive growth, tension in market supply and price inflation. Does the environment permit the effective use of indirect macro means? Under the conditions of 1) price structures and public finance remaining to be sorted out, 2) the market system is not yet complete and 3) enterprises are not in a position to react or respond quickly to changes in economic parameters, the use of indirect economic means to regulate the economy, either for aggregate control or for structural adjustment, could hardly be expected to yield all the desired results. Thus, the strengthening of macroeconomic control under present circumstances means instead having to resort to greater use of such direct administrative devices as quotas and norms, with the attendant arbitrariness and adverse effect on the normal operation of the economy. For example, the retrenchment that occurred in 1985-86, and again in 1988-89. Furthermore, direct administrative devices had been the methods the governmental administrative organs had used frequently. Habitual use of these, however, may easily lead to addiction, thus moving in the opposite direction of reform. In addition, loopholes in economic life have caused social problems by creating unjust distribution of income and certain abnormal practices. *Inter alia*, the abnormalities include 1) the country's inadequate legal system and law enforcement, 2) lack of inspection and supervision and 3) an imprecise and ambivalent policy.

To sum up, this section provides a sampling of some of the problems China has encountered in the reform process. Some of the problems may have been caused by mistakes or errors in work and were preventable; others may well be inherent parts of the reform process, as was discussed in the theoretical analysis of the earlier sections. Their origin may be traced to either the micro- or the macro-economic sphere, or to interaction between the two. One source of the problems

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26. Ibid., p. 68, Table 3.5.

27. See *ZHONGGUO TONGJI ZHAIYAO 1991*, (A Statistical Survey of China, 1991), Beijing: Zhongguo Tongji Chubanshe, 1991, p. 34.

may be the lack of coordination or dove-tailing of relevant reform measures; another may be the contradiction and friction created by the coexistence of both new and old systems. A "relaxed environment" has been considered essential for instituting price reforms, yet when inflationary pressure recedes after retrenchment, the sense of urgency for price reforms seems to disappear. Yet without price reform, enterprise performance cannot be correctly assessed, and without enterprise reform, price reform becomes pointless. The pace of reform itself again involves a dilemma: to avoid unacceptable shocks, the process has to be gradually implemented; yet a prolonged process breeds new contradictions and frictions. When one adds the constraints imposed by political and ideological considerations, the prospects for reform can hardly inspire optimism. The difficulty is compounded by the fact that micro and macro issues occur in juxtaposition in the real world and cannot be resolved in an orderly fashion as one can attempt to do in theory.

## VII. CONCLUSION

In conclusion, the following remarks are probably warranted. First, this paper began by asserting that some advocates of economic reform in China, like those in power, seem to favor a gradual approach. Our theoretical analysis has raised many issues which can be resolved only with changes in attitudes and behavior on the part of official policy-makers at different levels, entrepreneurs, ordinary workers and households. Institutions and modes of their implementation also require further changes. Actual cases observed during the past decades have largely confirmed this analysis. Hence the "equilibrating" process of "perestroika" is bound to take time and its dynamic involves a great deal of backing and filling: it is not unidirectional. This characteristic is, of course, by no means exceptional in a market economy and will not matter if fluctuations and subsequent adjustments are marginal in scale and short in duration. But the opposite is likely to be true in the Chinese case.

As time passes, several usually slow-paced changes in growth parameters can and will occur, thus complicating the process and aggravating it: the increasing size and changing age structure of the population and the growing scarcity of nonreproducible resources unless compensated by productivity increase through investment and improved technology. A second set of uncertainties consists of the rest of the world economy's ability and willingness to make up for the shortcomings of China's own economic dynamics. The size of the Chinese economy is a daunting obstacle to considerations predicated on exter-

nal aid and capital. Given these two sets of long-term factors, it would require a leadership possessing an unmistakable perspicacity to see the country's potential and actual situation.

Such a leadership dedicated to true economic reform will have to limit the size of the task while minimizing the opposition to reform and maximizing the magnitude of resources that can be brought to bear. To limit the task, the leaders would probably have to divide the country up for the purposes of reform into areas of varying priority, speeding up reform in an area that is already more developed while concentrating infrastructure investment in areas of lesser priority. To reduce the opposition to reform, the leaders must focus on retraining and one must consider more direct methods in "buying off" potential opponents to reform — for instance, pensioning off military and Party officials beyond a certain age. To bring more resources to bear, leaders will have to give priority to the privatization of state property, resolving the conflicting demands of justice and efficiency by bypassing many issues for final disposition later. In this way, China might increase the inflow of capital from abroad. Such leadership might even explore the possibility of converting the excessive accumulated stock of arms China has produced into an inflow of investment in the infrastructure of low priority development areas in China by offering the arms stockpile for use or disposal in effective schemes for global arms control. These are, of course, purely illustrative suggestions, because one can hardly provide a full reform program as an appendix to this paper. But unconventional political-economic thinking will be necessary in order to solve the huge problems which a post-Deng Chinese government will have to wrestle with if post-communist China is to have a new beginning at all. To this challenge, many will have to turn realistically and with daring.

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